

ICPS

International
Centre for
Policy
Studies

INSIDE UKRAINE

#10, July 2010

Table of Contents

NEWS OF THE MONTH	3
TOPIC OF THE MONTH: CUSTOMS UNION, WTO AND EU FTA	5
INTEGRATION – A HISTORICAL REALITY	5
CUSTOMS UNION, RUSSIAN-STYLE	7
UKRAINE NEEDS NO PHONY CHOICES	10
FROM COLONIZATION TO INTEGRATION	12

Editorial Board

Gaspar BERGMAN

Head of Secretariat, Soderkoping Process,
Kyiv

Vira NANIVSKA

Director of the ICPS

Nicu POPESCU

Research Fellow, European Council
on Foreign Relations

Olga SHUMYLO

ICPS supervisory board

Authors

**Volodymyr HRANOVSKIY
and Vira NANIVSKA**

Writing team

Maksym BORODA and Iryna PATRONYK

Researchers

**Ihor ZHOVKVA, Margarita RAYETS
and Roman BASALYHA**

Translation

Lidia WOLANSKYJ

Ukrainian Editor

Nadia TSISYK

Typesetting

Natalia POGORELOVA

e-mail: office@icps.kiev.ua
www.icps.com.ua/eng

News of the Month

Budget Code: Decentralize and consolidate

At the beginning of July, the Verkhovna Rada adopted a new version of the Budget Code, an event that made barely a ripple among Ukraine's voters. Nor did it rouse the turbulent public debate and widespread opposition that the draft Tax Code did in June. Yet, assessments of the latest changes to Budget legislation were an equally mixed bag.

The Budget Code increases the independence of local governments...

The new version of the Budget Code appears to completely match Viktor Yanukovich's campaign promises and to be in line with the strategic course taken by Party of the Regions to increase the independence of local budgets. According to Premier Mykola Azarov, eight national taxes and fees have been transferred to the local level. In addition, local governments now have the right to redistribute 25% of the state profit tax.

...but restricts their borrowing powers

Still, not all local government officials are happy about the budgetary innovations. The most highly criticized point is the serious restriction on the powers of local governments to use external borrowing as an instrument. In addition to already written-in requirements, caps on the size of debts and extent of guarantees were added. Cities will effectively be unable to independently seek financing to undertake large-scale infrastructure projects. The old system of "bringing tributes to Kyiv" offers little or no hope that municipal infrastructure will be modernized.

The trend towards consolidation that hides a real elimination of the democratic norms of separation of power has also infected Budget legislation. Yet another novelty in the Code is the considerable expansion of the powers of the President and Cabinet in the Budget process. The Budget Resolution that earlier was approved by the Verkhovna Rada has been changed to a Budget Declaration that no longer requires approval. The President's right to veto the Law on the State Budget has been changed to the option to return it for further review. This means that "inefficient" debate has been removed from the Budget process and switched for a swift and highly efficient making of decisions that cannot be challenged.

Local elections revert to the mixed system

Freedom of choice

On 10 July, the Verkhovna Rada passed a new version of the Law "On the election of deputies to the legislature of the Autonomous Republic of Crimea," local councils and village, town and local mayors." From now on, local elections will be based on a majoritarian-proportional system without the participation of blocs of political parties. Only representatives of actual parties whose branches are registered in a given town, county or village for at least 12 months prior to the election may be nominated for office.

These changes to electoral law were a consequence of widespread public political consensus about the ineffectiveness of the proportional system at the local level. Now, in addition to recognizing a political "brand," candidates for office will have to demonstrate their ability to deal with the problems that concern their voters.

The new law works against the government's rivals

Critics accuse the authors of this new law of trying to weaken the position of their political rivals. Prohibiting the participation of political blocs will make life much more difficult for the Bloc of Yulia Tymoshenko (BYT) and the Volodymyr Lytvyn Bloc (VLB), while the timeframe required for registering party offices and the requirement that electoral commissions be formed exclusively of representatives of parties that hold seats in the Verkhovna Rada severely restrict the options of new political forces, such as Serhiy Tihipko's *Sylna Ukraina* [Strong Ukraine] and Arseniy Yatseniuk's *Front Zmin* [Front of Changes].

Pastoral visit

The Constitution of Ukraine states that the church and the state must be separate. Yet, neither Ukraine's last President nor the current one has been particular about remaining outside church matters but has, on the contrary, always been actively engaged. Under Mr. Yanukovych, the interconfessional dialog launched by Mr. Yushchenko has taken on new features, although the first point on its agenda remains unchanged: the split between the Kyiv and Moscow Patriarchates. The urgency of this issue on both sides of the Ukrainian-Russian border was underscored by the fact that Kirill, Patriarch of Moscow and All-Rus, has visited Ukraine three times since his election in 2009.

The battle for Ukraine's faithful becomes politicized

His Holiness's intention of subordinating Ukrainian Orthodoxy to the Moscow Patriarchate fits smoothly in with the latest integrational trends in relations between the two countries. Moreover, a personal aspect has been added to state affairs. On one hand, President Yanukovych and Patriarch Kirill have a long and close relationship. On the other, analysts say that Russia's political leadership is not enamored with the very independent, active and public role of the head of the Russian Orthodox Church. This adds a political tinge to the battle for Ukraine's flocks, not only in Kyiv, but also in Moscow.

Topic of the Month

Customs Union, WTO and EU FTA

Integration – a historical reality

Integration has been a process involving all times and all peoples. As soon as the earliest states emerged, they began to interact and therefore to integrate. From the point of view of goals, war and trade have really been mere instruments of integration.

The history of humanity is a history of empires. The First and Second World Wars, the collapse of the colonial empires, the Soviet and European Unions—these are only some of the most significant examples of integrational processes on a global scale in the last century. They resulted in a shift from traditional models of relations between independent nation states—colonies or metropolises—towards the creation of superstates as the foci of competing integrational unions.

The current and future spheres of influence of such superstates have been defined by students of geopolitical trends long ago. Ukrainian analysts look only at two possible options for Ukraine: Russia or the EU. Moreover, the country can only passively select to join itself to one of the two for the simple reason that Ukraine itself cannot become an empire.

*Ukraine's
integrational role
is decisive*

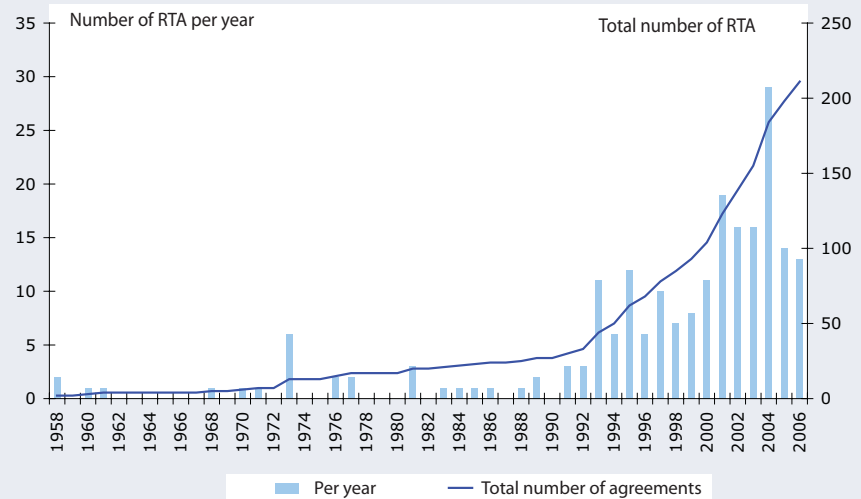
Meanwhile in the West, at least two well-known international thinkers, Jacques Chrétien and Zbigniew Brzezinski, were talking about the key integrational role of Ukraine, regardless of the country's desires and understanding. Ukraine finds itself right between two integrational centers. Although the country itself has no superstate ambitions, Mr. Chrétien declared that Ukraine would determine the shape of the Eurasian region in 30 years: a Chinese hegemony at the borders of Europe or a powerful Euroatlantic democratic society that stretches to the borders of China.¹

Zbigniew Brzezinski stated that any new Eurasian union of states that develops around Russia without an independent Ukraine, will inevitably become less European and more Asiatic with every passing year."²

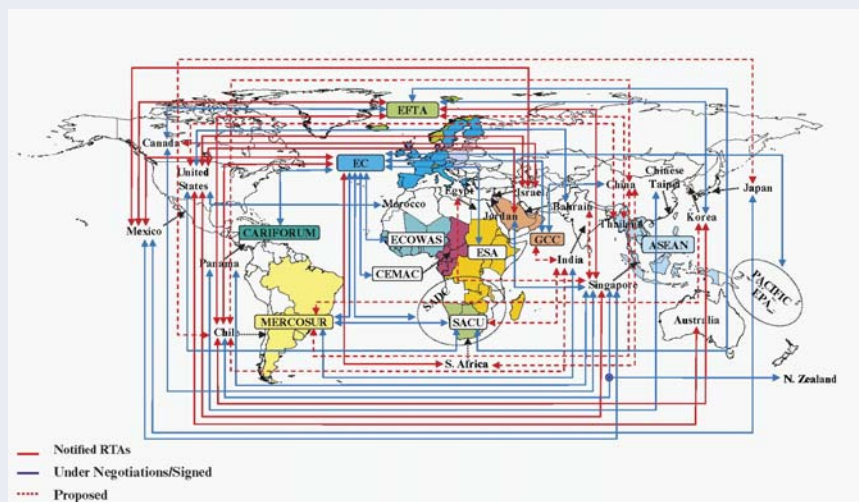
¹ Speech by J. Chrétien at the first YES Summit.

² The Grand Chessboard by Z. Brzezinski, 1997.

Active trade agreements, based on effective date and status



Source: www.wto.org



Source: *The Changing Landscape of Regional Trade Agreements* by Jo-Ann Crawford and Roberto V. Fiorentino, WTO Discussion Paper №8, 2005

*The principles
underlying the EU
maintain a balance
of interests*

For many centuries, history reveals mutual integration processes that have become particularly intense in the 20th and 21st centuries. This has helped work out workable integrational principles and mechanisms that allow a balance of interests and influence to be kept among different members of an integrated association. The EU is a classic example of this kind of "principled" integration.

Enormous historical experience is the best argument in favor of a determined adherence to European principles. These are a guarantee of stability in an integrated association and of the ability of such a union to withstand both external and internal challenges. Conversely, violating these principles carries serious

*A 15% decline
in GDP will lead
to uncontrollable
social processes*

threats for all sides. These include international conflicts and civil wars, social chaos and dictatorships.

These threats become even more serious during a period of economic decline. According to some studies, a sharp fall of over 15% of GDP in any country leads to uncontrollable social processes and can easily result in a popular explosion. Historical examples abound: the coming of the Nazis to power in Germany, the Russian Revolution, the collapse of Yugoslavia, and so on. Clearly, Ukraine demonstrates a sufficiently hopeful signs of economic revival that, for now, make such events extremely unlikely. Still, unresolved structural problems coupled with a difficult economic situation in Europe make it hard to talk about the economic crisis in the past tense.

Customs Union, Russian-style

*Russia continues
to "collect land"*

Russia continues to play its traditional role as the driver of integrational processes in the post-soviet region, a process that has been referred to as "collecting land." In July 2010, Russia moved one more step in the direction by launching a customs union with Kazakhstan and Belarus.

It would seem that the classic name of this integrational institution, whose definition can be found in every textbook in international economics, leaves little room for creative maneuvering by its founders. According to WTO rules, a customs union is a single customs territory that involves canceling all customs duties and restrictions among the member countries, instituting a single customs tariff for goods from third countries, and carrying out a common foreign trade policy.

On paper, at least, the members of this new Customs Union show that they understand these points. But the agreed conditions under which this new integrated entity will function contain such a large number of exceptions and unregulated issues that it remains a customs union in name alone. According to the signed documents, there are more than 400 exceptions to the free movement of goods. Moreover, customs control will be maintained at the borders of the member countries as well as non-tariff trade barriers such as quotas and subsidies. Among others, Russia is maintaining its export duty on oil and oil products to Belarus, while Belarus is holding onto its export duty on transporting Russian oil across its territory.

Nor does the newly-formed Customs Union require the members to uphold a single customs policy. Typically, issues regarding the use of trade protection instruments are supposed to be raised before a single authorized national agency set up for this very purpose, in order to coordinate a common customs policy. In the case of Russia, Belarus and Kazakhstan, however, their various Governments have the last word.

*Russia's new
Customs Union
cannot rightly claim
to be one*

In short, the Customs Union between Russia, Kazakhstan and Belarus cannot rightly claim to be one, as it does not correspond to the basic elements and principles for such a union. Moreover, the new integration project is not even a free trade area, the simplest form of integration there is, as it does not in fact do away with internal duties and tariffs on imported goods.

Interestingly, even the initiators of this project have admitted as much. After all, Premier Putin has announced several times that canceling all restrictions on trade with Russia, that is, a proper Free Trade Area, will only be possible if there is an economic union. According to the classical logic of integrational processes, this is the same as defending a PhD thesis, not just without a degree but without even finishing school.

The concepts of "free trade area," "customs union," and "single economic region" in this context lose all economic meaning. The Customs Union in Moscow's way of thinking has two main features that reveal its essentially political nature.

*Russia has
the controlling stake
in this Customs Union*

Firstly, Russia has the controlling stake in this 170-million Eurasian expanse. The distribution of votes in this supra-national body called the Customs Union Commission is such that Russia has 57% while Kazakhstan and Belarus have only 21.5% each. All decisions are made based on a two-thirds majority vote, which means that Russia can always block any decision it chooses.

Disputed issues are supposed to be reviewed by higher bodies of the Customs Union: interstate councils of Heads of Government and Heads of State, where all decisions are consensual. Still, if Moscow succeeded in persuading Minsk and Astana to agree to these conditions of operation in the new integrational entity, nothing will stop it from further ensuring that its partners in the union will agree to the "necessary" decisions.

Even more obvious is the scheme for distributing customs duties within the Union, which, incidentally, constitute a significant part of State Budget revenues for all three countries. So far, Russia and Kazakhstan have agreed to divide the revenues so that 86.5% go to Russia, 8.5% to Kazakhstan, and 5.0% to Belarus. Belarus's dissent and its attempts to cut a deal for an additional 0.3% of duties looks more like agreeing the terms of capitulation and not like cooperation among equals.

Incidentally, similar principles of hegemony in the distribution of votes operated in all previous integrational project launched by Moscow in the post-soviet Eurasian region. For instance, EAEA, the Eurasian Economic Association within which the Customs Union operates, distributes votes on the basis of 40% to Russia, 15% each to Belarus, Kazakhstan and Uzbekistan, and 7.5% each to Kyrgyzstan and Tajikistan. Decisions are traditionally made on a two-thirds majority basis, that is, 66% of the vote. Again, no decisions can be made without Moscow's concurrence.

*The Agreement
on a Customs Union
was first signed
in 1995*

The second peculiarity of a Russian-style Customs Union is the exceptionally "flexible" way in which its principles are applied. For instance, member countries can maintain trade barriers for their most significant commodities, such as fuels.

The concept of integration whose forced realization Ukrainians are currently watching with bated breath has been percolating in the brains of Russia's leadership for many a year. Recent events have been merely the latest attempt at reviving the integrational dinosaur that has been peacefully sleeping its papery sleep from the time it first arrived in the world in faraway 1995. That was the year Belarus, Kazakhstan, Kyrgyzstan and Russia signed an agreement to form a Customs Union.

In time, this virtual project changed shape more than once, evolving first into the EAEA in 2000 and then into the UES in 2003. But new names failed to bring these initiatives to life. They continued to exist mostly as reminders of the fact that Russia retains for itself the role of integrational center in this region, rather than as functioning mechanisms for true regional cooperation.

Russia's integrational initiatives

<i>Date of founding</i>	<i>Name</i>	<i>Membership</i>	<i>Ukraine's role</i>
December 1991	CIS	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan	Founding member and participating state, but not member Did not sign CIS statutes
September 1993	Economic Union (EU)	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Ukraine, Uzbekistan	Associated member Did not sign founding Agreement
January 1995	Customs Union (CU)	Belarus, Kazakhstan, Kyrgyzstan, Russia	Not a member

Date of founding	Name	Membership	Ukraine's role
October 2000	Eurasian Economic Association (EAEA)	Belarus, Kazakhstan, Kyrgyzstan, Russia, Tajikistan	Observer status
September 2003	Unified Economic Space (UES)	Belarus, Kazakhstan, Russia, Ukraine	Participates with reservation

Ukraine needs no phony choices

Moscow has made it be known to Kyiv that the about-face in relations with Russia that President Yanukovich was so keen to establish leads to the Customs Union. The rules of courtesy demand that the open invitation issued by Premier Vladimir Putin be offered an equally open answer. However, following the rules of diplomacy, official Kyiv is in no hurry to dot its i's.

On 13 February 2010, the newly-elected President of Ukraine announced that he was positive about the idea of joining a Customs Union with Russia.³ Yet barely two and a half months later, at a PACE session on 27 April, Mr. Yanukovich declared: "Joining the Customs Union with Russia, Belarus and Kazakhstan is impossible today."⁴

As Deputy Chair of the VR Foreign Affairs Committee Leonid Kozhara explains: "Ukraine could join the Customs Union on the basis of multi-speed integration... Ukraine could integrate into the Customs Union at a different pace and on a different basis from Kazakhstan and Belarus."⁵ Deputy Premier Serhiy Tihipko adds: "Russia and Ukraine will return to the question of a customs Union just as soon as Russia joins the WTO and Ukraine gets its Association Agreement."⁶

The dilemma that is causing Ukrainian officials some concern is that the country cannot simultaneously join a Customs Union with Russia, Belarus and Kazakhstan and set up a Free Trade Area with the European Union. The EU position was clearly presented by Eurocommissioner Hugh Mingarelli:⁷ "If Ukraine feels it must join this Customs Union, it will become extremely difficult to set up a Free Trade Area with the EU."

Indeed, regardless of how nominal the name "customs union" is for this joint integration project by Russia, Kazakhstan and Belarus, Ukraine's active involve-

Joining the CU would make it impossible to set up an FTA with the EU...

³ According to the Forum information service.

⁴ According to UNIAN, a news agency.

⁵ According to Ukrinform, a news agency. See <http://project.ukrinform.ua/news/16580/>

⁶ According to wto.in.ua.

⁷ Deputy General Director at DG External Relations for ENP.

*... and violates
WTO rules*

ment will undoubtedly put an end to the country's Eurointegration ambitions, even in such modest instances as a Free Trade Area with the EU. After all, forming a Customs Union means that Ukraine will join the common external tariffs of three countries with whom the EU has barely liberalized trade.

What's more, joining the Customs Union also violates Ukraine's commitments as a member of the WTO. The rules of this trade organization require that the level of protection of markets in a customs union not be higher than the level of protection in the countries that have initiated it. This means that the common tariff in the CU cannot be higher than those conditions under which Ukraine joined the WTO. Such a situation is highly unlikely, given that at this time the customs tariffs collected by the new Union are 92% Russian customs duties.

Assessments of the costs and benefits of joining differ. Russian analysts⁸ calculate that joining the Union will bring Ukraine 3 – 5% more annual growth in GDP. By contrast, former Finance Minister Viktor Pynzenyk⁹ says that Ukraine's State Budget will lose US \$1 billion a year in revenues from customs duties not received. Undoubtedly, both points of view have some basis in reality. However, the terms for distributing customs duties among members of the Union and the fact that income from them is the lion's share of revenues in Ukraine's State Budget will force a more cautious position towards this integrational proposition.

*Many Ukrainians
falsely believe
that the inevitable
choice is Russia
or the EU*

The dominant paradigm in Ukraine's foreign policy is that, sooner or later, the country will have to choose between the EU and Russia. Given this mistaken notion, the more active work of the Ukrainian Government in the Russian integration arena automatically slows movement towards the European Union.

Despite the President's optimistic announcements about signing an Association Agreement by the end of this year, the prospects of Ukraine's joining a Free Trade Area with the EU are becoming ever more clouded. Negotiations stalled the minute talk switched from discussing general issues to agreeing concrete commitments. Lobbyists are spurring Ukraine's negotiators not to concede a single point under cover of national interests. At this point, the positions that remain unresolved include:

- The geographic identification of product origins: Ukraine defends Sovetskoye "champagne" and Zakarpattia "cognac" as though they were national inventions, although everyone knows quite well that this is a hopeless confrontation;
- Agriculture, sanitary and phyto-sanitary norms: These remain Ukraine's weakest point in the negotiation process and therefore this area needs the greatest changes;

*FTA talks with
the EU have
stalled*

⁸ Data based on a presentation by Kirill Dmitriev, president of Icon Private Equity, a fund, at a public hearing organized by the Effective Management Fund.

⁹ Interview with V. Pynzenyk in Ukrainska Pravda. See <http://www.pravda.com.ua/articles/2010/04/2/4904589/>

- Duty rates: As a classic example, Ukraine wants to protect its non-existent domestic car industry, possibly as a cultural-ethnic heritage;
- State procurements: Like its predecessors, the latest Law also fails to meet basic EU requirements.

From colonization to integration

The Customs Union is not an instrument for economic integration

An examination of the principles that lie at the foundation of the Customs Union between Russia, Kazakhstan and Belarus and the conditions under which it operates offers a basis for stating that this is not a customs union but a different instrument altogether. A sample of the principles on which colonial policy was developed in the 18-19th centuries by European states includes:

- Streamlining trade routes and markets and eliminating intermediaries;
- Ensuring trade by unifying the legal arena and trade policy;
- Gaining access to cheap labor for physically hard, demeaning work;
- Testing and working out new ways and means of managing;
- Intervening in local conflicts and using armed forces for the purpose in order to keep the army battle-ready;
- Expanding the reach of the Russian language and culture;
- Acquiring and exploiting economic assets;
- Forcing international agreements and arrangements regarding unified policies, concessions, leases, and so on.

Russia is establishing colonial relations in the post-soviet region

When looked at from the position of "colony-metropolis," it becomes obvious what type of relations Russia is building in the countries that belong to its sphere of influence. And it has growing confirmation that Ukraine is among these.

Still, an aggressive integrator is not necessarily a successful integrator. Alexander the Great, Genghis Khan, Napoleon Bonaparte, Adolf Hitler, and Josef Stalin all had grandiose visions of integration by conquest. Still, none of them lasted much beyond the lifetime of their initiator.

Trade integration is a much more long-lasting and convenient approach for most countries. The best confirmation of this is sustained presence of the British Commonwealth, which continues to include most of the former colonies of the British Empire, all of whom have become strong, independent nations.

In the modern world, colonial relations no longer work

Moreover, colonial empires mostly collapsed half a century ago. The reason for this was that, in a modern, globalized world, colonial relations are ineffective, both for the colony, which loses the ability to independently develop and freely make use of its own resources, as for the "metropolis," which, in time, finds itself forced to direct more and more resources at maintaining peace and order in its colonies than it actually gains from them. The result is an inevitable collapse of the colonial empire, which carries the risk of social upheaval and conflict for both sides.

The EU is the only union that has gone through all stages of integration

This has been obvious to European countries for some time already, as they build mutual relations based on a balance of interests. Today, the European Union is the only real international union that has gone through all the stages of integration, from free trade area to monetary union, and that continues to move forward.

The reason for this success and longevity is undoubtedly the way the rules of integration have been upheld, when the terms "free trade zone" and "customs union" have clear economic meanings and do not turn into political projects. Conversely, any talk of Ukraine's further integration in the post-soviet arena should take place not on the basis of horse-trading for preferential fuel prices but on the basis of European integrational principles. Before beginning discussions about forming a customs union, there should be a proper free trade area that, among others, conflicts with neither WTO rules nor Ukraine's Eurointegration ambitions.

Ukraine's leadership understands perfectly well, what is really going on with integrational processes in the country. It is not a question of the capacity of Ukrainians: The Government has all the necessary organizational, intellectual and decision-making qualities. The question is more how aware they are of the cost of inaction and the ruinous long-term consequences, for all participants. Kyiv's relapse into a hypnotic state induced by Moscow's snake-charms is turning into subordination to an unknown and currently non-existent center. From this point of view, the role of willing sacrifice to integration Russian-style that the opposition has eagerly taken upon itself, is hardly better than the position of passive ally placed upon the government.

The motives for integration hidden within an unreal customs union are, firstly, Russia's problem and not Ukraine's. The illusion of immediate benefits for all the countries that have chosen such short and deceptive pathways to integration bode little good. Ukraine has all the leverage it needs to establish high-quality integration with Russia. Taking a pro-active position, naming things what they are, and consistently planning and carrying out all the necessary steps will bring both sides the most benefits. Bringing Russia closer to the EU and the US is possible only if regional integration follows Euroatlantic principles.

*Russia will not
survive an explosive
Ukraine*

Through sheer inertia, Russia is going down the path of European countries in the 18th and 19th centuries, setting up delayed-response mines along all of its own borders: Georgia, Kyrgyzstan, Kazakhstan and Belarus. Right now Moscow is stubbornly working to set the biggest mine of all, Ukraine. If Ukraine explodes, Russia will have a very hard time surviving.

Russia is the biggest integrational center in the Eurasian region and has embodied this particular mission for several centuries. Still, times change and what worked once upon a time can be very destructive today.

Russia has the strategic capacity to plan and carry out its plans. It has balanced relations with key central powers and it belongs to the largest integrational associations in the world—the G8, G20 and SCO. But Russia's Achilles' heel is its unreformed system of government and this is playing a decisive role today in integrational processes that are following a double standard. Right now, Russia has a unique opportunity to develop a new integrational platform with Ukraine, following modern European principles.